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PANAMA

COUNTRY DEVELOPMENT STRATEGY STATEMENT

FY 1988 - 1992

February, 1986

I have reviewed the USAID/Panama FY 1988-92 Country Development Strategy Statement and find the proposed program of assistance to be consistent with U.S. Policy and supportive of our goals and objectives in Panama.

Arthur H. Davis — 2/13/87

Arthur H. Davis
Ambassador

Date

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I. ANALYSIS

A. Macroeconomic Assessment

1. Economic Growth Performance

During the decade of the 1960s, Panama's real GDP grew at the annual average rate of eight percent, one of the highest rates of sustained economic growth in the world. The benefits of economic growth, however, were concentrated in a relatively small segment of the population, and the social and economic infrastructure outside the metropolitan corridor remained at a relatively low level of development. The military government which took power in October 1968 introduced major social and economic reforms, while attempting simultaneously to sustain the rapid GDP growth experienced during the 1960s. Between 1968 and 1973, the GDP grew at an annual rate of 7.3 percent and basic needs indicators began to show significant improvement.

During the 1970s, the real economic growth rate was lower but still respectable, but in the 1980s it dropped sharply. In the 1970s the unemployment rate stayed essentially constant. An acceptable unemployment rate was maintained by means of three explicit policy measures: (1) a massive program to increase school attendance and retention at the secondary and university levels which caused the labor force participation rate for Panamanians between 10 and 24 years of age to fall by 10 percent from 1970 to 1980; (2) a reduction in the minimum retirement age (from 65 to 60 for men and from 55 to 50 for women), so that the labor force participation rate of those 55 and older dropped by 10 percent during the decade; (3) increases in direct, public-sector employment (7.5% per year) which accounted for approximately 80 percent of the increase in total employment in the economy. The rate of increase in public-sector employment slowed in the first four years of the present decade (to 5.6 percent per year), but the government still represented the primary source of new jobs. In 1984, for example, 7,500 new jobs were created in the public sector while the number of private sector employees decreased by 5,400.

All three of these policies to limit unemployment have entailed additional costs (in retirement benefits, school funding, and government salaries), and have exacerbated Panama's current fiscal and foreign debt problems. For this reason, it has been recognized that relying on that strategy is no longer a viable option, and public expenditure levels for those purposes are being reduced in real terms. At the same time, Panama's labor force will increase by about 23 thousand persons each year over the medium-term, and job creation is running 10-15,000 positions behind the number of new entrants to the labor market each year. Unemployment, therefore, is an immediate and growing problem for the Panamanian economy.

Several factors have contributed to the slowdown in real economic growth in Panama in the 1980s. The three most important appear to be a sharp drop in the rates of saving and investment out of total income, a stagnation in export growth, and an increase in the share of export earnings devoted to debt repayment, which reduced the amount of money available for importing raw materials and manufactured inputs.

According to the official national accounts of Panama, investment accounted for 23.6 percent of GDP in 1980 but only 14.4 percent in 1985. Most of that decline was caused by a drop in domestic savings, but also net foreign savings became increasingly negative in the 1980s.

The real export growth rate had been seven percent per year in the 1970s, but from 1980 to 1985 it declined to 1.3 percent per year. The sharpest declines in export levels occurred in tourism earnings and petroleum product exports, although exports of sugar and fish meal and oil also declined significantly. With the increase in net foreign capital outflows, imports were lower in the years 1983 and 1984 than they were in 1980, 1981 and 1982.

For the period 1980-85, the average rate of growth of imports was only 1.2 percent per year.

As a consequence of these various forces, the annual growth rate of real GDP slowed from 5.5 percent in the 1970s to 2.7 percent in the 1980s. This has meant very little change in real per capita GDP (+0.5% per year) in the last five years. By sector, the most disappointing growth performance since 1980 has been registered in the manufacturing sector, with a slightly negative growth rate (-0.4% per year), versus a positive annual growth rate of 3.6 percent in the 1970s. The decline in investment depressed the construction sector, and petroleum refining declined. The general economic recession also depressed the non-food consumer goods industries, particularly in the now rebounding textiles sector.

Agriculture's growth performance was somewhat better at 3.2 percent per year from 1980 to 1985. By far the most positive growth factor was the opening of the transisthmian oil pipeline at the end of 1982. In real terms, activity in the Colon Free Zone had declined in the 1980s and earnings from the canal were approximately constant. The Colon Free Zone activity has improved over the past year.

The financial restructuring of the country's debt has forced a measure of fiscal austerity and slowed the growth of indebtedness. Still, Panama's external debt (though moderate relative to other L.A. countries) is one of the world's highest in per capita terms, and Panama will experience net capital outflows estimated at $230 million per year during at least the next five years. The economy's adjustment process may trigger further reductions in real wages and/or an increase in unemployment[1/] and consequently, a

1/ See Arnold C. Harberger, Panama's Fiscal and International Debt Crisis, One Problem or Two, 1984.

worsening of the country's distribution of income. In fact, real wages declined slightly between 1980 and 1985.

In light of all these developments, Panama is searching for a new development strategy that will both rekindle the growth momentum and provide some economic relief to lower income groups. Generating more private sector employment would appear to be a an essential ingredient of such a strategy. The need to change strategies and to give greater emphasis to the private sector became apparent in 1982 when several events, including cost overruns in La Fortuna Hydroelectric Project and a scandal-associated program of housing construction financed by the Social Security Fund, helped boost the fiscal deficit to the unprecedented level of 11 percent of GDP, almost twice the amount stipulated under the GOP's stand-by arrangement with the International Monetary Fund (IMF). The government worked to reverse that situation, and between 1982 and 1985, total public (current plus capital account) expenditures declined from 28.1 percent of GDP to 20.6 percent of GDP. Unfortunately, most of that decline occurred on capital account.

After no significant change in aggregate real income in 1983 and 1984, 1985 was a year of recovery; real GDP growth in 1985 was 4.1 percent. Most sectors of the economy experienced positive growth:

MAIN COMPONENTS OF GDP (1985)

	% of Total	Real Growth (%)
Agriculture	9.1	+4.8
Mining and manufacturing	8.7	+1.8
Utilities	4.4	+7.6
Construction	4.7	-1.1
Colon Free Zone	2.7	+10.9
Finance and Real Estate	12.0	+3.9
Commerce, Restaurants, Hotels, Other Services	23.5	+2.4
Pipeline	4.4	+15.1
Panama Canal Commission	7.0	+1.5
Government Services (including tariffs)	17.4	+5.1
Transport/Storage, Communications	6.1	+1.0

Note: The percentage shares are calculated from 1985 price data provided by the Contraloría General de la República in December of 1986.

Much of the recovery in 1985 can be attributed to improved performance in the international service sector (especially the petroleum pipeline and the free zone), to increased electrical generation, and to a stronger-than-average performance by agriculture. The balance of the domestic economy, especially construction, domestic transportation and manufacturing, fared far less well. It is noteworthy that the fisheries sector began to show signs of take-off, with real value added in that sector increasing by 42 percent in 1985.

Macroeconomic indicators for the first several months of 1986 suggest that economic growth during the year will be modestly positive. Panama Canal traffic, the Colon Free Zone and the banking sector are all registering gains. Inflation remains low, the trade picture is improving, and government finance appears to be better managed. On the other hand, the construction, manufacturing and traditional agriculture sectors performed sluggishly.

In agriculture, banana shipments, Panama's largest single export, were off by 16.9 percent during the first four months of 1986 as production dropped due to a crippling strike. Sugar exports in the first quarter were cut in half compared to 1985 levels due principally to the reduction in U.S. quotas. On the positive side, coffee exports recovered and the fishing industry's prospects improved --the shrimp catch rose 25.6 percent in the first quarter.

Construction activity declined with the value of building permits during the January-May period off 8.6 percent compared to the same period in 1985. While the middle-income housing market was active, boosted by a law establishing preferential interest rates on certain mortgages, heavy construction was down as a result of severe cutbacks in government-financed infrastructure improvements. The reduced rate of overall investment in the economy continues to affect the construction sector.

During the first quarter, Panama's index of industrial production fell 3.3 percent. Growth in manufacturing appeared to be affected by uncertainty over the impact of the industrial incentives law and labor code reforms, weakness in several related sectors (especially agriculture and construction), and the drop in crude oil refining.

While the domestically-oriented part of the economy did not perform well during early 1986, the picture was considerably brighter for the international service sector. The Colon Free Zone trade continued to climb and revenues from the Panama Canal increased 8.9 percent over the corresponding January-May period for 1985. Panama's banking center registered modest growth with both domestic and off-shore deposits expanding over the last 12 months.

It is expected that Panama's inflation will remain low and that electricity production will continue to rise. Some improvement in the tourist sector is also expected. (See 86 Panama 11286 for a summary of 1986 macroeconomic indicators.)

Panamanian authorities have expressed their intention to pursue economic policies that will achieve satisfactory growth and improvement in the external account over the medium-term. Based on these policies, the IMF scenario assumes that real GDP will grow by three percent per year and that the average annual rate of inflation will be three percent. In the unlikely event that Panama cannot negotiate a restructuring of its commercial external debt, its situation in the period 1987-91 could be extremely precarious. (See IMF, Panama: Staff Report of the 1986 Article IV Consultation" for a full treatment of these issues.)

2. Government Policy

Panama's economic policies differ markedly among sectors. While the service sector (especially banking and the Colon Free Zone) has prospered as a result of minimum government regulation and control, there has been significant intervention by the State in other sectors, most notably in agriculture and industry. These interventions have generally dampened the vigor and growth of the sectors involved. Labor policies initiated during the early 1970s and producer demands for protection have led to a relatively high-cost economy. The rising unemployment of the 1980s halted the growth of real wage rates, and the Labor Code revisions of 1986 removed some of the restrictions that artificially raised the cost of labor, but Panama still needs to improve its production cost structure through productivity improvements.

Agricultural policy in the past decade emphasized self-sufficiency in basic food commodities through price support policies and import controls. This added to the public-sector deficit, and misallocated resources. In spite of the protection against imports, real price incentives have declined in the sector since 1978, partly as a result of declines in world market prices, and this trend has contributed to a reduction of output growth rates in agriculture.

Although price policy was intended as a mechanism to transfer income from urban to rural areas, any redistribution which was achieved favored large and efficient producers. This effect, along with deterioration in terms of trade for agriculture, resulted in major outflows of human and capital resources to the service sector during the 1970s. Other government interventions were the establishment of government-owned enterprises, such as sugar mills, silos and the agricultural mechanization service, and the creation and support of agrarian reform communal farms (asentamientos). Public employment in the agriculture sector and in the government as a whole mushroomed. The Ministry of Agricultural Development (MIDA) emphasized the provision of social services and gave relatively less emphasis to promoting agricultural production by private farmers. As a result, real value added per capita in Panama's agricultural sector was more than 10 percent lower in 1984 than it was in 1970.

In the industrial sector, the policy of import substitution, which began in the early 1960s, was continued. Domestic industries were protected through a system of import quotas and tariffs. The domestic prices of items subject to quotas were also regulated and the protection rates became very uneven over industries. Studies indicate that, while the average rate of effective protection has changed very little from 1969 to 1983, the dispersion of protection has increased by a factor of ten. Firms which have been highly protected have an interest in maintaining the old system, and have resisted full application of the new Tariff Reduction Schedule. As a result, improvement in production efficiency has been only marginal to date.

The construction sector accounts for 4.4 percent of GDP and six percent of employment. In the past, construction benefited from Panama's growth as a banking and commercial center. More recently, government policy stimulated housing construction through tax incentives which reduced home buyer's monthly payments and increased effective demand. This stimulated investment in residential construction, particularly in the middle-income housing markets.

As a whole, the construction sector is affected by the inefficiencies of the protected domestic industries, which result in excessive materials and labor costs, high tariffs on imported components, and excessively complicated procedures for building permits and approvals. The future of the construction sector will depend in part on sustaining the demand for housing through improved employment and income, and through lower production costs. It also will depend on the recovery of commercial construction, which in turn, will result from general acceleration of economic growth, and upon an upturn in government construction which will require an increase in the GOP investment budget.

The set of policies outlined above resulted in a misallocation of resources and constrained growth in all sectors, with the exception of the service and government sectors. One of the first studies completed in the Development Policy Studies Project calculated that if the general efficiency of the Panamanian economy had been maintained at the level of the 1960s, even with no technological progress in the 1970s, the amount of new investment and new employment should have produced a GDP 20 percent to 30 percent larger than it was in 1980. Instead, the decision to stimulate the economy fiscally to compensate for the lack of private-sector involvement resulted in levels of government spending which greatly exceeded revenues and which led to excessive levels of foreign and internal indebtedness. Total, cumulative public sector debt increased from 32 percent of GDP in 1970 to almost 100 percent in 1983. Efforts to correct this debt situation will severely constrain future foreign borrowing by the public sector, so economic growth in Panama now depends on the reactivation of the private sector. This can be achieved only through the development of a free market environment and the provision of production-enhancing technology.

Such a redirection of economic policy is not universally welcomed in Panama. There is significant opposition from groups which benefit from present policies, including leading members of the coalition of parties which won the national presidential elections. The policy reforms legislated in March 1986 caused widespread strikes and business protests. Nevertheless, the reforms of the labor code and the industrial and agricultural laws represent genuine, if limited, progress. The fact that the Delvalle government took such reforms in the current environment in Panama underscores the seriousness of the fiscal crisis and the pressure which external donors are bringing to bear on Panama's fiscal management.

B. Economic Prospects

1. Financial Stabilization

A two-year financial package was successfully negotiated with the IMF in July of 1985 providing Panama with 90 million SDRs in additional external funding. The GOP's immediate problem was to comply with the budgetary conditions of that stand-by agreement. In light of the continued heavy debt service, the adjustment program for 1985-86 was directed to consolidating the earlier progress in strengthening public finances. The program originally envisaged a decline of the overall deficit of the non-financial public sector from 5.9 percent of GDP in 1984 to 3.5 percent of GDP in 1985, and subsequently to 2.6 percent of GDP in 1986. This was to be achieved through measures to strengthen the revenue base, to reduce the rate of growth of current outlays and to scale down investment expenditures. The overall public sector deficit was to be fully financed from external sources with no recourse to National Bank of Panama credit.

Panama's performance in 1985 under the stand-by arrangement was mixed. The overall deficit of the non-financial public sector was reduced to 1.7 percent of GDP, well below the program limit of 3.5 percent. This was achieved, however, as a result of shortfalls in external credit disbursements which led to lower than projected current expenditures and investments. This shortfall arose in large part from failure to negotiate in a timely manner a second structural adjustment loan from the World Bank (SAL II). At the end of 1985, the IMF considered Panama to be in non-compliance with the stand-by agreement.

Panama's performance under the stand-by arrangement was satisfactory in the first two quarters of 1986. The ceiling on National Bank credit was observed with a modest margin. The non-financial public sector registered a surplus of $2.4 million compared with a targeted deficit of $25.9 million. The limits on total external borrowing and on commercial borrowing were met with large margins.

For 1986, net external financing to the non-financial public sector was projected to be $125 million, including a disbursement of $50 million under SAL II and $15 million under the U.S. Economic Support Fund (ESF). (Only $5.7 million of ESF was actually disbursed during 1986, and $50 million will be disbursed under the SAL during December 1986). The financing package also included a rescheduling of $354 million in amortization payments to foreign commercial banks falling due in 1986. Moreover, the non-financial public sector was to make a net repayment of $63 million to the National Bank of Panama to strengthen its liquidity.

Overall, Panama has made commendable progress in strengthening the finances of the public sector. Expenditure control efforts should now concentrate on current expenditure, as a further curtailment of investment expenditure could have adverse consequences for the country's growth prospects. Despite this progress, however, the IMF observed that Panama will return to a sustainable external position only in the medium term, and that the restructuring of Panama's commercial debt as well as some net new commercial bank financing may be needed in the next few years to support Panama's adjustment effort.

Panama's revenue sources are diverse, and include a wide range of service fees. Total tax revenues amount to about 20 percent of GDP, high in relation to revenue rates of countries with similar per capita incomes. Tax collection processes, formerly somewhat loose, have been improved since the onset of the fiscal crisis; VAT collections alone were up 25 percent in 1986.

A process of economic reform began with the De la Espriella administration's sharp controls on fiscal spending in 1983 and some initiatives under the first World Bank SAL. While some unambiguous measures have been taken, progress in privatization has been painfully slow. The most inefficient sugar mill (Felipillo) was closed, and a luxury hotel was sold. COFINA, the state finance company, has ceased lending operations and the BNP will serve as trustee for collecting COFINA's outstanding loans. Recently, the GOP leased the IMA (Agricultural Marketing Institute) silos, sold ENDEMA (National Machinery Company), closed ENASEM (National Seed Company) and sold the Alanje Sugar Mill. Steps have been taken to sell the Contadora Hotel, Aeroperlas and the Hotel Panama. A number of studies on state enterprises have been carried out.

In March, 1986, the National Assembly passed three incentive laws covering labor, industry and agriculture. The labor code revisions loosens restrictions on productivity premiums, piece work, and contract work in the home, and it increases the probationary period of new workers to three months. These provisions are intended to attract new foreign and domestic investment to Panama.

The Industrial Incentives Law reduces tariffs on currently protected products in equal steps over five years. At the end of the fifth year no single tariff can exceed 60 percent *ad valorem* of the C.I.F. price of the imported item. In the case of products which are deemed to be important to the national economy, however, tariffs can be as high as 90 percent *ad valorem* of the C.I.F. price of a similar product. New products cannot have a tariff protection higher than 20 percent *ad valorem*, with the exception of agro-industrial products for which the tariffs may not exceed 30 percent *ad valorem* of the C.I.F. price of a similar imported item.

The Agricultural Incentives Law maintains the role of MIDA in technology generation and transfer and the quality control of agricultural products through grading and standards, but reduces the role of the GOP in price fixing and market controls. It encourages greater participation of producers and consumers in the formulation of agricultural policy. Implementation of these provisions will require modification of institutions, establishment of new regulations, and training of civil servants to perform regulatory functions. These steps will not be easy to carry out. In some cases, careful transition studies will be required, and in others (such as the proposed tariff reforms) policy monitoring measures may be needed.

2. Economic Growth

2.1 Agriculture

The agricultural sector, including crop production (9.1% of GDP) and agro-industry (4.6% of GDP), was second to the service sector[1/] with a contribution of 13.7 percent of GDP in 1985. If wholesale and retail trade in agricultural inputs and outputs were included, agriculture's share of GDP would be about 20 percent. During the 1960s, the real GDP in the agriculture sector grew at a rate of 5.3 percent per year, but that rate fell to 1.5 percent per year in the 1970s. Agricultural output, in real per capita terms, was twelve percent less in 1983 than in 1970. However, agriculture's growth rate improved in the 1980s, and the sector continues to be a major contributor to the national economy by providing a) a food supply which is more than adequate for domestic consumption, b) a production surplus that

1/ Panama's service sector dominates the economy. It generates 69 percent of GDP and proportionally is the largest of any developing country in the world. Components include the Canal, domestic and off-shore banking, the transisthmian pipeline, the Colon Free Zone and the government and defense forces.

contributed 90 percent of merchandise export earnings in 1985, c) a basis for the agro-industrial sector, which is the most important part of the manufacturing sector, d) employment for more than 30 percent of the total labor force, and e) household incomes for the 50 percent of total population that live in rural areas, with the corresponding contributions to consumer demand.

Nevertheless, the role of agriculture in Panama's economy has declined, owing in part to government policies which since 1968 have emphasized import substitution, direct state production, and extensive development of rural infrastructure rather than investment in productivity improvements, e.g. agricultural research and irrigation and soil management. The result was an agricultural sector that was highly protected in some areas and faced unusually high costs of inputs. In contrast, the market-oriented service sector grew rapidly during the same period. As terms of trade for agriculture declined, labor and capital resources moved into the service sector. While the importance of agriculture relative to services has declined worldwide, this trend was accelerated in Panama due to market distortions and the weakness of programs for improving agricultural productivity.

Panama's agricultural performance also has been low relative to its potential. Most of its production increases have come from expanding land under production, from 1.18 million hectares in 1950 to 2.25 million hectares in 1980; a large part of that increase took the form of extensive use of pasture lands, rather than intensifying crop land. Given Panama's mountainous terrain, total agricultural land accounts for less than 30 percent of the total land base, and annual and perennial crops occupy only six percent of the land base. However, land itself is not the primary limiting factor to increased agricultural production, but rather the low average yields per acre.

New technologies of production are not widely diffused in Panama. The following table shows that crop yields in Panama are lower than in South America on average in seven of eight major crops.

YIELD COMPARISONS FOR SELECTED CROPS, 1981
(KG/HA)

Crops	Panama	South America	North America	International Average
Rice	1,694	1,782	5,462	2,285
Corn	927	2,212	6,863	3,370
Dry Beans	260	520	1,611	567
Sorghum	2,245	3,192	4,025	1,507
Sugar Cane	49,800	57,230	88,802	56,102
Potato	12,517	11,116	29,166	14,387
Cacao	274	538	n/a	358

(Sources: FAO Statistical Yearbook, Office of the Comptroller General and World Bank estimates.)

The potential to increase yields is high, a potential which has been tapped only in bananas, industrial tomatoes, poultry and dairy production, and a few other specialized products. Adaptation and transfer of known technology could increase crops three to five times on the highly productive upland soils, and two to three times on lowland soils. This is especially important for the land- and labor-intensive fruit and vegetable crops which have high returns per acre and strong domestic and international demand. Also, natural mangrove and artificial salt pond production of shrimp could be expanded from the present 2,300 hectares to about 15,000 hectares.

Panama has a natural comparative advantage in the production of grass-fed beef, although recently price controls and marketing policies have discouraged production growth. Until the last twelve months, beef prices have been set well below world levels, and exports have been restricted by quotas. Panama has never filled its U.S. quota, yet it has the capacity to export 20,000 head per year. Although at present the export prices of beef are extremely low, Panama has the potential to greatly reduce its unit costs in beef production through improved pastures, herd management techniques, and veterinary services.

Panama's most important agricultural and agro-industrial exports are bananas, seafood, sugar and coffee. There is additional land available with good potential for bananas, but high labor costs and disease problems are restricting expansion of this crop.

On average since 1976, Panama has exported 13 percent less coffee than its International Coffee Organization export quota of 4,000 metric tons. Changes in agricultural policy in favor of exports and rising coffee prices have motivated new plantings and the construction of two new processing plants.

While sugar has been a major export crop, Panama's climate is less than ideal for this crop, resulting in cane which has a low sugar content and leading to high refining costs per pound of sugar. World sugar prices peaked at 30 cents per pound in 1980, but have plummeted since then to a low of three cents per pound, with a poor outlook for future prices. Panamanian consumers pay at least twice the free international price for sugar. Production costs are high and several state sugar mills are closing down.

Self-sufficiency has been achieved in rice, with a substantial surplus as well. Support prices at double world market prices have made this crop very profitable for a small number of large, relatively efficient producers. In turn, the Government of Panama has been forced to sell surplus rice at a considerable loss on the international market.

Panama has considerable potential for producing tropical fruits, fruit juices, vegetables and cacao. The potential is particularly high in citrus, mango, papaya, passion fruit, pineapple and melons if they are grown on irrigated land which is now being used for lower-valued sugar cane and rice. Bell peppers, celery, asparagus, cabbage, cauliflower, strawberries and cucumbers which are grown at higher elevations have potential for export into the U.S. winter market. The window for the winter market is narrow, however, making this a highly seasonal activity. Also, competition for this market from Central American and Caribbean countries will increase, and the strong competition from Mexico will continue. Expansion of cacao has been limited to date by disease, but improved cultivation practices show economic potential.

In the agricultural sector, the measures taken by the Government from 1983 through 1985 in response to the SAL I agreement were minimal; a state owned sugar mill was closed; farm support and consumer ceiling pricings were lifted on two crops (potatoes and first quality coffee); the farm support price on rice was reduced by one cent per pound; and import quotas were shifted to import tariffs on 25 food commodities.

In March 1986, the National Assembly passed the new Agricultural Incentives Law. This Law sets the stage for freeing domestic prices and for reducing the barriers protecting agriculture production from external competition. Implementation is slow, however; implementation plans are being developed under MIDA's first Five-Year Plan.

The new World Bank structural adjustment loan (SAL II) was signed by the Government on December 12, 1986. Its terms were made public in August 1986. Those terms, when implemented, will move Panama further toward an open, competitive economy. According to SAL II, the government will eliminate producer and consumer price controls, reduce import duties, suspend government purchases of agricultural commodities, end export quotas on all major agricultural commodities, and sell the major state agricultural enterprises. The Government of Panama has initiated a process of fundamental reform of agricultural policy. Until those reforms take effect, efforts to increase agricultural production and productivity will have limited impacts.

2.2 Growth Sectors

The analyses and recommendations of various studies of the Panamanian economy are unanimous on one point: the domestic market offers insufficient prospects for economic growth. The sectors which appear to offer fair to excellent export possibilities include financial services (banking and insurance), agro-industry, light industry, and international transport.

Financial Services: Banking has been a major growth sub-sector over the past fifteen years. Its direct employment generation effects are quite limited, but secondary employment in construction and related services is more extensive. The growth of this sub-sector is for the most part based on external factors. Some expansion can be expected from deepening the services offered by banks, especially through the transfer of operations done in parent countries, and seeking out foreign personal accounts through trust operations. Also, the insurance sub-sector has some potential for growth, primarily in the field of reinsurance. The financial sector, through increased efficiency, new offerings and promotion, can continue to progress marginally. However, major growth of the sector will depend upon growth of other economic sectors (see International Transport).

Agro-Industry: The rational exploitation of marine-based resources, production of non-traditional products, as well as increased penetration of the U.S. winter vegetable and fruit market offer considerable potential for increased income through agriculture exports. Several constraints, however, need to be dealt with: (1) low production levels, uncertain quality and high prices; (2) lack of adequate channels between producers and commercial outlets; and (3) lack of internal commercial infrastructure and access to export markets. Marine products offer the best possibilities, along with crops which are specialized for seasonal markets.

Light Industry: The assembly industry offers both short- and long-term possibilities for export. Despite the three main constraints to Panamanian competitiveness (labor, energy and transport costs), other conditions make Panama attractive for investment in production facilities which could serve North American markets. Product lines with potential include electronic components, metal stamping and assembly, furniture, ceramic tiles and garments, among others.

International Transport: Panama's location and the existence of the Canal constitute a permanent advantage as a trans-shipment point. This has been recognized in studies carried out by the Planning Research Corporation (PRC) which anticipates the development of the entire Canal corridor as a "Center-Port" where major maritime carriers can off-load and on-load to and from distributory carriers which serve Central and South American ports. "Center-Port" would also stimulate activities in the banking and insurance areas.

C. Major Development Problems

1. Economic and social status as measured against A.I.D. strategy and CAI goals

A review of Panama's economic and social indicators reveals that Panama surpasses the minimum goals of the Agency Strategic Plan and the Administrator's Message regarding basic needs and the growth rates of population and the economy (refs. A & B of the FY 1988 A.I.D. Programming guidance). Panama does not require bilateral projects addressing hunger, disease, illiteracy or population growth. From a viewpoint of that Strategic Plan, the minimum standard for economic growth is an annual real growth rate of per capita income of not less than two percent. Over the last two decades, Panama's growth performance has been well above that standard, but it should be recognized that currently, as a result of Panama's financial and economic problems, real per capita income is showing very little improvement.

In response to the instructions in the guidance cable, we considered the goals of the Central American Initiative as set forth in the FY 1985 Congressional Presentation. As is the case with the overall Agency strategy standards, Panama generally exceeds the education and health standards described on pp. 12-13 of Volume II, Annex III of the FY 1985-CP. The GOP's greatest success during the 1970s was in extending basic public services to small towns and rural areas while expanding high quality coverage in urban areas. Panama's economic and social indicators are within the range typical of middle-income countries. However, the pattern of improvements in social services that occurred in the 1970s cannot be continued in the 1980s, given the effect of austerity measures. With national cutbacks in funds for local services, the future quality of life of Panama's cities and towns will decline unless local capacity for generating revenues and providing services improves.

By many quantitative indicators, Panama's educational system is one of the best in Central America. In 1982, the estimated literacy rate was 85 percent, and participation rates in the primary, secondary and post-secondary age groups were 88.2, 62.4 and 20.5 percent respectively. A recent human resources sector study[3/] concluded that Panama should be able to meet the CAI goal of 95 percent primary school enrollment by 1989 without USAID assistance. Very recent shortfalls of resources threaten attainment of this goal, however.

In the standards set forth in the FY 1985 Congressional Presentation, infant mortality was to be reduced to 50 per thousand by 1989.

3/ Central America Education Action Plan for Panama, April 1985, Klitgaard and others.

In Panama the rate is already 20 per thousand. Access to potable water is enjoyed by 85 percent of the population, and to systems for excreta removal by 90 percent. Contraceptive use is high in Panama. A recent family planning prevalance survey indicated that 96 percent of all married women and 92 percent of unmarried women had knowledge of contraceptive practices and that over 60 percent of all married women were using some form of contraception. Correspondingly, Panama's rate of population growth has declined since 1970 and now stands at 2.19 percent by some estimates, which is low by Latin American standards. Despite the notable success in reducing the birth rate, Panama's demographic characteristics, young age structure, high adolescent fertility and limited government resources could lead to a slowdown or reversal of the present trends.

In 1980, public sector low cost housing production was about 900 units. The rate of construction of low-income housing was planned to be increased by 25 percent by 1989. As indicated in our NBCCA tracking system reports, low income housing construction increased 24 percent in 1981, 206 percent in 1982, 32.8 percent in 1983 and 88.7 percent in 1984. This housing was constructed entirely by the public sector through A.I.D.'s Housing Guaranty program. The Panama Urban Development Assessment (UDA), published in January, 1985, indicated, however, that there was a wide gap between Panama's implicit promise of minimally acceptable housing for all citizens and recent rates of housing investment. Based upon census data, it was determined that approximately 86,000 of the 240,000 housing units in urban areas were so dilapidated that they could not be improved, were over-crowded, or needed to be upgraded. An assessment of shelter needs, conducted as part of the UDA, indicated that 15,000 units in urban areas would be required annually over the next five years and that 10,000 of those units would be needed by below median income urban families. Formal housing production for the urban poor over the last seven years has fallen far behind the needs of this lower half of the urban population. The result has been a burgeoning of squatter areas in the Panama metropolitan areas and secondary cities. These illegal invasions are a source of political and social conflict and strain the network of public services and facilities.

2. Development Problems

a. Government Policy: Panama's current set of economic development policies is the major constraint to growth. Intervention by the State in almost all aspects of the economy has stifled the private sector, produced an inefficient, over-sized and highly centralized public sector, distorted prices, decreased employment, and reduced the competitiveness of exports in international markets. Public sector spending financed by international borrowing has produced an international debt that now requires austerity measures of such severity that merely maintaining current levels of social services in such areas as health, education, water, electricity and roads may prove impossible. Important policy changes are underway, but they need to be continued and deepened. The process of transition to a more open economy requires structural changes in institutions and in their rules of operation. These must be closely monitored and unanticipated problems need to be recognized and addressed promptly as they emerge.

b. Public Debt and Financial Situation: Largely as a result of the policies described above, Panama has accumulated a public sector debt which is close to 85 percent of GDP, with a debt service which amounts to about 34 percent of public sector revenues. Stringent austerity measures have been taken, largely at the expense of the investment budget and non-salary portions of the operating budget.

c. Unemployment: As noted above, until recently, employment problems were dealt with by increasing public sector employment and reducing labor participation rates. These devices are no longer available and, once again, unemployment is a serious concern. The World Bank has estimated that unless a structural adjustment program is implemented, the open unemployment rate would increase significantly by 1989.

d. Productivity: Government interventions in the productive sectors have led to an increase in factor costs, e.g. labor, electricity and transport. Private firms, nurtured on protectionism, have not been forced by competitive pressures to use production factors with skill. To successfully compete in world markets Panama will have to make major improvements in productivity in all sectors of the economy.

e. Agriculture: In the agriculture sector in the 1970s, the Government of Panama instituted fixed farmer support prices and fixed consumer prices on major crops and livestock products, import controls through high tariffs and quotas, exclusive licensing authority for most agricultural processing and marketing activities, and exclusive import rights by the state for major food products which were purchased at low world prices and resold at the artifically high domestic prices. The economic effects of the State's agricultural policies included 1) reduced production efficiency, 2) no economic incentive for adoption of improved technology, 3) distorted relative and absolute prices which did not reflect consumer demand and producer response, 4) limited marketing efficiency, 5) restricted market entry and monopoly control throughout the marketing chain, 6) economic windfall gains to selected producers, processors, and input suppliers, and 7) generally high consumer food prices (except in beef) without correspondingly high producer prices. Also the government has been involved in direct production of agricultural products which has resulted in very inefficient enterprises.

f. Natural Resource Management: Unmanaged exploitation of land in Panama has had adverse consequences for both short and long-term development. The principal deleterious land use systems in Panama include slash-and-burn farming, extensive grazing, uncontrolled logging, and upland farming without soil conservation practices. Such practices lead to deforestation, increased soil erosion, decreased water retention, and irreversible long-term environmental impacts. The present utilization of soil, water, and forests is unplanned and fragmented. Each user is concerned with immediate extraction of benefits and does not consider the sustainability of the natural resource base. Current output has remained constant or even risen, but at the expense of future production. The commercial forests of Panama will be exhausted within two decades if present rates of forest depletion continue. Soil erosion clogs the rivers and reservoirs of the Panama Canal and silts hydroelectric facilities, reducing the life expectancy of this vital infrastructure. The Canal watershed is particulary valuable and must be mantained and managed properly. These problems are recognized in Panama, but programs to deal with them need strengthening.

g. Centralized Public Services and Local Government: Almost all basic local services in Panama are provided by central government agencies. Along with basic infrastructure like water and sewerage, these include police and fire protection, town and regional planning services, street maintenance, and (in the metropolitan area) garbage collection. Panama is the only one of 55 developing countries for which data are available where the net flow of fiscal resources is from local government to central government. Towns collect revenues which are then used to reimburse central government agencies for provision of services. Centralization on this scale has created several problems. First, it has deprived citizens of the experience of making budget choices and weakened local democratic institutions that could respond to citizens needs. Second, it has contributed to the inefficiency of Panama's public sector. Third, some important services are not being provided.

h. Fragile Democratic Institutions: The 1984 general elections brought a directly elected civilian president and legislative assembly to office after 16 years of military rule. Although the elections of legislators and mayors were considered, with a few notable exceptions, democratic and free from electoral scandal, it is widely believed in Panama that the presidential election victory was engineered by the Panama Defense Forces (FDP). Despite its formal withdrawal from political power, the FDP continues to wield considerable influence over presidential, legislative and judicial decision making, and had a major hand in President Barletta's abrupt removal from office in September 1985. In this area, there is a clear need to foster a greater understanding among the governing elites of the importance of democratic institutions and inviolable, open procedures of governance.

i. Administration of Justice: The Panamanian Constitution provides for habeas corpus, requires warrants for arrest, protects against self-incrimination, and promises fair and expeditious trial, among other rights of due process. However, the judicial system also suffers from severe resource deficiencies, which result in lengthy case backlogs, overcrowded detention facilities and inadequately trained judicial and law enforcement officials. Juvenile delinquents are occasionally tried and incarcerated as adults, youths and poor people are sometimes detained and pressured during interrogation to confess to crimes they have not committed, and many detainees are held for up to a year or more awaiting trial. In addition, there have been recent cases of official harassment of media representatives who have publicly criticized the government or the military, and there are widespread allegations that many judicial officials are subservient to the FDP.

Deficiencies in administrative procedures give rise to practices which would be unacceptable under U.S. civil or administrative law. It appears that instances of administrative and transactional irregularities are widespread. Though corrective actions have been taken in response of particularly glaring irregularities, there is a widely held perception that major administrative reforms will be required to improve Panama's ability to engender desired levels of foreign and domestic investment.

j. Economic Opportunities for Women: Women are accorded equal rights with men under the Panamanian Constitution. While women enjoy full political and social freedom, they still do not have the same opportunities for advancement in employment. Female employment in urban Panama is still concentrated in less prestigious and lower paying jobs; however, there is ample evidence of upward occupational mobility. Although the Constitution mandates equal pay for equal work, as in many countries wages for women are frequently lower than those for equivalent work performed by males. Panamanian Law does not recognize community property. Hence, divorced or deserted women are often left destitute. This remains a serious problem.

II. STRATEGY

We note from the foregoing analysis that the "basic needs" criteria set out in The Strategic Plan of the Agency for International Development, June 1985 have been met in Panama. The country has relatively high per-capita GDP and income is reasonably well distributed. An extensive social infrastructure provides near universal education, widespread health and family planning services, and social security. However, the economy which supports that infrastructure is seriously flawed. Its poor performance now threatens to erode past social gains and add to the ranks of the unemployed.

The military-linked governing coalition is supported by a constituency with vested interests in maintaining the present economic structure. We believe that economic necessity will force the GOP, albeit reluctantly, to further adopt free market, export-oriented growth policies. However, the necessary changes can be accelerated by adjustment of the political processes which now impede the evolution of economic policy.

The combination of a flawed economy and flawed political processes with the attendant potential for unrest and instability leads us to develop our strategy in light of Panamanian, regional and U.S. security interests.

The USAID strategy, presented herein, is predicated upon the conviction that the orderly economic development and the continuing democratization of Panama will serve the security interests of the U.S. and the broadest interests of the Panamanian people. Foremost among U.S. security-related objectives is to create, foster and sustain a climate which will ensure the continued safe, efficient and dependable operation of the Panama Canal, both now and after termination of the Panama Canal Treaty at the end of the century. The relationship between these security interests and the economic, social and political evolution of the region has been underscored by the National Bipartisan Commission on Central America which recommended that A.I.D. economic assistance be directed to:

* Arrest declines in incomes, employment, and economic activity through major balance-of-payments assistance;

* Establish the basis for long-term economic growth through improvements in economic policy and the infrastructure needed to export.

* Assure the widest possible distribution of the benefits of growth through assistance aimed at improving health, education, and housing for the poorest groups, and

* Support democratic processes and institutions through assistance for the administration of justice, technical training, and the development of leadership skills.

The USAID/Panama strategy is derived from the Commission's recommendations and conditioned by the unique circumstances evident in Panama.

A. Objectives

The purposes of the first two recommendations of the Bi-Partisan Commission can be met by: (1) extending free-market conditions throughout the economy which would reduce production costs and permit Panama to compete in world markets, thus establishing a basis for long-term growth; and (2) removing constraints which impede the private sector's ability to respond to fre market opportunities, thereby increasing economic activity, income and employment. These accomplishments would permit Panama to maintain and expand its present humane and equitable social infrastructure, which would respond to the third recommendation of the Commission. We, therefore, have selected growth as the main focus of our economic strategy.

1. Economic Objective

From a review of the opportunities and constraints which confront the Panamanian economy, we have formulated, what we believe to be an attainable economic objective. The USAID will assist in the further development of a free market economy capable of a sustained GDP average annual growth rate of five percent over the next five year period. USAID and other donor agencies are convinced that an export-driven, free market offers the only reasonable instrument by which such growth can be attained, and that improved productivity and adjustments in the role of public institutions also are necessary conditions for that growth objective. While the availability of external resources will affect growth prospects, the magnitude of GDP growth also will be determined in large part by the depth and tempo of policy changes and the ability of the private sector to respond to such changes.

The IBRD projects a "base case" Panamanian aggregate annual growth rate of about 3.5 percent over the next three years (1986-89) and an "optimistic case" rate of nine percent. They also consider a "pessimistic case" in which the growth rate is 1.6 percent. The "base case" anticipates an encouraging policy climate and moderately favorable external price levels. The "optimistic case" anticipates more rapid and deeper policy adjustments, excellent external demand and price levels, and a rapid response to export markets.

For our program planning purposes, this range of alternative scenarios is too broad to be operationally useful. Therefore, USAID has developed a set of two growth scenarios, one which is an extrapolation of the trends of the 1980s to date, and the other a somewhat more optimistic case. The alternative real GDP growth rates in the two cases are three percent and five percent, respectively. The three percent growth case is in fact the basis of the IMF's projections, it assumes a rescheduling of Panama's commercial external debt. Tables 1 and 2 display the growth assumptions by sectors of the two cases.

The five percent growth case assumes moderately more favorable external conditions and continuing implementation of economic policy reforms. Based on Panama's history, the five percent growth rate is quite feasible, provided that export markets are sufficiently favorable and foreign capital inflows are sufficient to help offset most of the debt repayment requirements. A pre-condition for the more rapid growth is that the past burden of excessive domestic economic controls be lightened so that the competitiveness of the private sector can be restored.

TABLE 1
GDP GROWTH RATES BY SECTOR: HISTORICAL PERIODS AND ALTERNATIVE PROJECTIONS
(percent per year)

Sector	1970-80	1980-85	1985 - 1991 Base case	1985 - 1991 Target Case
Agriculture	1.5	3.2	2.0	3.5
Mining and manufacturing	3.7	-0.4	2.0	3.7
Utilities, domestic transportation, communications	n.a.	13.9	6.0	8.0
Construction	6.2	-6.9	2.0	7.0
Financial services	n.a.	2.2	2.0	4.0
Canal related income	n.a.	6.6	5.0	6.6
Other private services	5.2	1.5	2.2	4.5
Government services	4.0	5.3	2.4	3.7
GDP	5.5	2.7	3.0	5.0

TABLE 2
ALTERNATIVE PROJECTIONS OF GDP BY SECTOR
(millions of 1965 balboas)

Sector	1985	Total: 1985 - 1991 Base case	Total: 1985 - 1991 Target Case
Agriculture	444.7	500.8	546.6
Mining and manufacturing	424.4	477.9	527.8
Utilities, domestic transportation, communications	509.1	722.2	807.9
Construction	227.6	256.3	341.6
Financial services a/	585.9	659.8	741.4
Canal related income b/	690.0	924.7	1012.5
Other private services c/	1149.3	1309.6	1496.7
Government services	850.5	980.6	1057.7
GDP	4881.5	5826.0	6532.2

a/ Net of the inputed banking sector interest.

b/ Earnings from the Colon Free Zone and the transisthmian oil pipeline, plus the commission from the canal.

c/ Domestic wholesale and retail trade, restaurant and hotel services, "communal, social and personal services", and personal domestic services.

The annual gross fixed capital requirement for the attainment of the five percent growth rate is estimated at about $853 million (1985 dollars). This is not high by past standards. The existing capital stock is underutilized and growth in certain sectors will not require major new capital outlays.

The "base case" scenario anticipates a 2.5 percent growth in exports; the target case, an increase of 6.5 percent. This is considerably smaller than the rate which the IBRD uses in its optimistic case scenario. Given the small export volume upon which increased rates are calculated, the anticipated percentage growth is probably conservative.

Net private and official borrowing by the public sector, plus direct foreign investment, was $305 million in the period 1980-83. On the basis of World Bank estimates, it may be said that the "base case" scenario corresponds to net external public sector borrowing (including direct foreign investment) of about $200 million in 1987-89. If the growth rate is higher, the need for foreign assistance may be lower.

It is calculated that attainment of the five percent growth target will result in creation annually of more than 16,500 jobs on average over the 1986-1991 periods, and also net average annual increases of more than $90 million in government revenues.

The five percent growth rate scenario produces about 7,100 more jobs annually than does the "base case" scenario. Nevertheless, such a level of employment generation will be insufficient to absorb the approximately 23,000 new workers who will enter the labor market each year. The resulting growth in unemployment rates could well contribute to unrest. The GOP is faced with Hobson's choice; it must make painful structural adjustments now or more difficult structural and political adjustments later. If now, these adjustments and the assistance of external donors could eventually bring the growth and employment rates up to the required levels.

2. Social/Political Objective

Both the realities and perceptions of Panama as a "democratic" nation have profound effects on the welfare of individuals, social stability, the political process, domestic and foreign investment and the role which Panama will play in the Central American arena. The improvement of political and judicial processes which will be required to improve Panama's democratic image and performance receives notional support from all quarters, and real support from those who are frustrated or hurt by their present imperfections. From the U.S. point of view, we regard such improvement as a self-evident requirement for pursuit of individual and common welfare.

The USAID therefore fully endorses and will actively pursue as its second objective the unaltered recommendation of the National Bi-Partisan Commission on Central America. We will "Support democratic processes and institutions through assistance in the administration of justice, through technical training and the development of leadership skills." This objective is not readily quantifiable, and its degree of attainment will be determined more by the success of its processes than by changes in institutional forms. We will measure progress by noting the extent to which political institutions become increasingly responsive to the public will, and the degree to which public policy and programs become increasingly subject to public scrutiny, and the extent to which citizen participation at all levels of the political process is broadened.

The accomplishment of these two objectives will establish the fundamental base upon which all the social and economic objectives of the Bi-Partisan Commission can be met, and by which those already met can be maintained.

B. T‘e USAID Role

The IMF, through its stand-by agreements, provides support to and monitors the fiscal performance of the GOP. The IBRD, through its Structural Adjustment Loan agreements, provides additional support linked to conditionalities set out in those agreements. The financial resources committed to Panama by those agencies (massive compared with USAID inputs) are intended to cushion the economic and fiscal impact of a faltering economy while it undergoes transition, and to influence the direction of policies during that transition. USAID resources are intended to influence the transition and to contribute to the success of the new policies. Therefore, the strategy outlined herein takes into account the contributions of the other agencies, complements and builds upon their initiatives when appropriate, and directs limited USAID resources to those purposes which will produce the greatest economic benefits. We expect that the IBRD and the IMF will continue to take the lead in introducing major structural adjustments. USAID will focus its activities on the implementation of those adjustments at the sectoral level.

C. Addressing the Constraints to Growth

The constraints on investment and economic growth imposed by past GOP policies have been identified, and under pressures generated by the IMF agreements and the IBRD Structural Adjustment Loan, are being addressed by the GOP. Aside from the political impediments to policy development and its successful implementation, the GOP does not have sufficient technical capability to carry out policy analysis. Neither does it have adequate administrative capability to administer effectively those new policies and new regulatory roles. USAID will assist in reducing these constraints. The ability of the private sector to respond to free market policies is constrained by low productivity, inadequate availability of long-term finance, inadequate capital mobilization, and unfamiliarity with the external markets in which producers are expected to compete. USAID will assist in the removal or reduction of these constraints.

The ability of the GOP to maintain the existing social infrastructure and to devote resources to essential physical infrastructure is constrained by its support of uneconomic government enterprises and by the burdensome costs of maintaining an unnecessarily large bureaucracy. We will assist in activities to bring about reductions in government current outlays.

USAID's three strategic thrusts: (1) advancement of free market policies, (2) improvement of Panamanian production response to those policies, and (3) reduction in current costs of government operations, are pursued under four broad initiatives. Those initiatives will be directed to sectors which have the highest overall growth potentials and which can be most affected by external interventions. While immediate social benefits, viz. employment generation within the sectors, will be sought, we will not encourage socially motivated distortions of the capital-labor mix. USAID believes that production entities will make their greatest contributions to overall economic growth and employment by optimum utilization of production factors.

1. Initiatives in Support of Private Sector Investment

Fortunately, important elements in the GOP share the view held by USAID and the international donor agencies that major economic growth can occur only if led by the expansion of Panamanian export sectors. The emerging changes in GOP policies reflect that view. They call for a decrease in protectionism and an increase in Panamanian participation in world markets, a reorientation of agricultural production toward crops which can be produced competitively for international markets, an elimination or reduction in the incidence of price controls, and a modification of the counter-productive elements of the labor code.

USAID's first private sector initiative will, therefore, direct resources to influence, complement, reinforce, and render operative those emerging policies which (a) contribute to improvement in the competitive position of Panamanian producers, (b) advance a free market economy, and (c) remove those bureaucratic obstacles which impede investment and business operations. We will provide assistance to key government agencies to improve their capacity for policy analysis with special emphasis on rationalizing the system of price controls and regulations, and on improvements in the administration of the commercial and labor codes.

Implementation of policies already modified, and of those which will be promulgated during the planning period, will require structural and operational changes in Panamanian executing agencies. USAID will direct resources to support selectively such restructuring, with the understanding that the agencies selected will reduce their regulatory roles, refocus their activities to facilitate private sector initiatives and make significant reductions in personnel. USAID's limited restructuring effort is essential for effective administration of new policies, and it may also influence restructuring of other governmental entities as a prelude to civil service and public administration reforms, with attendant fiscal benefits.

USAID's second private sector initiative is intended to foster increased investment, production, and sales through technical assistance to the private sector. Early success of these efforts would contribute to continued policy evolution. The development of favorable policies by the GOP will not alone be sufficient to generate the required investment. The business community and organized labor must be able to respond to policy change. Their members and organizations are ill-equipped to do so. Industry and agriculture, nurtured on protectionism and subsidy and enjoying semi-monopolistic positions, are generally inefficient, oriented almost exclusively to the domestic market, and are relatively high cost. Under pressures generated by scheduled reductions in protective tariffs and growing awareness of the market opportunities offered by the Caribbean Basin Initiative (CBI), important elements of the business community have shown increasing interest in export markets and in improving their ability to participate in them. Two conditions are necessary for their significant participation in those markets: (a) a flow of market information, and (b) improvement in the cost structure of Panamanian enterprise. USAID will direct resources to generate the required information flows and to achieve cost reductions through productivity improvement.

Our support of appropriate free market policies by the GOP and of productivity improvements in the private sector are inextricably linked. We have noted that the policy changes already made by the GOP were undertaken in the face of fierce opposition from both opposition parties and from substantial elements of the governing coalition. It is likely that such opposition will continue to impede additional desired policy changes, unless it can be demonstrated that the policies produce the desired economic results. USAID support to the private sector is intended to advance the acceptance and success of the new agricultural and commercial policies, by assisting it to accommodate to the discipline of and to attain the rewards offered by a free market. Moreover, we are aware that if examples of such accommodation and success are not forthcoming, producers and labor unions may seek political relief, thus jeopardizing the evolution of free market oriented strategies of the GOP. USAID's Industrial Relations Development OPG (525-0275) is assisting the Confederation of Workers of the Republic of Panama (CTRP) to improve its leaders understanding of national issues and their capacity to assist affiliated unions to bargain collectively in a more effective fashion.

USAID's third private sector initiative, the provision of adequate developmental finance, is already underway. The Export Development Finance Project (525-0261), which provides for long and medium-term credit for export production, has been initiated. The Small Business Project (525-0240) is in its second year of operation, and is successfully leveraging private monies for lending and investing in small enterprise. The Agriculture Cooperative Marketing Project (525-0222), which provides credit for agricultural production, is now active. Thus, small but critical USAID-supported developmental credit supplemented by private development credit is available. More restrictive lines of long-term credit are available from the National Bank of Panama (BNP), and short-term lines are readily available from commercial banks.

USAID foresees the possibility of adding to long-term credit lines as economic growth picks up, or inducing portfolio shifts in commercial banks by instituting guarantee programs or other innovations. Given the housing sector's economic and social impact, we may institute an additional Housing Guarantee Program, if the housing sector continues to lag.

USAID is aware, however, that Panamanian growth in the long run will require mobilization of domestic savings for developmental purposes. We will carry out capital market studies and search for policy and institutional designs which can channel increased domestic resources into the investment stream.

2. Initiative in Support of Public Sector Investment

Appropriate modifications in the role, operation and size of government could permit reallocation of funds for critical investment needs. Reductions in government workforce and privatization of state-owned enterprises would make for significant savings in the GOP budget. The conditionalities of the World Bank Structural Adjustment Loans (SAL) and of the FY 1985-86 ESF agreements require that Panama initiate a program of divestiture of state enterprises. The SAL also calls for a two percent reduction in the government workforce during 1986, and the amendment to the FY 1986 ESF agreements calls for public workforce reductions through attrition. USAID will direct resources to facilitate GOP compliance with these conditionalities.

Both privatization of governmental enterprises and reductions in government payrolls are politically charged issues. Some progress has been made in privatization, but apparent irregularities in the disposition of recently privatized parastatals have caused even the proponents to reduce their degree of support for the privatization process. Although much of the opposition to privatization and workforce reduction is grounded on political outlook or expediency, even advocates are concerned that the two efforts will increase unemployment. Unless the private sector is able to absorb the workers released, these two efforts are likely to be circumscribed and pursued with little enthusiasm. It is likely, therefore, that the pace of privatization and workforce reduction will be related to the pace of economic growth. Conversely, the GOP's real commitment to a functioning and effective free market economy may well be conditioned by its urgent need to place redundant government workers in private industry. Cognizant of its controversial nature, USAID will therefore continue prudently to assist the GOP to carry out its programs of privatization and workforce reduction.

The most pressing obstacle to privatization in Panama -- as, indeed, in all countries involved in similar programs -- is the social impact of large scale uncompensated dismissals. Given current budgetary constraints, the GOP cannot readily muster the resources needed for termination payments to workers who are made redundant by privatization. The USAID will examine the feasibility of providing ESF for support of the Panamanian investment budget during the period when government expenditures in support of privatization are higher than the net savings which privatization will engender.

D. Guidelines for Improvement of Democratic Processes

The introduction to Panama of the Regional Administration of Justice program elicited an unsually high degree of sensitivity from the GOP, although several justice sector institutions have shown considerable enthusiasm for program offerings. While continuing to be alert to official sensitivities, we will remain open to opportunities for strengthening cooperation with public and private sector institutions wishing to participate in Administration of Justice program initiatives. These initiatives will (1) seek to influence the values and outlook of future leaders, (2) apply generally accepted broad principles to specific areas of public concern, with particular emphasis on strengthening the labor-management dispute resolution process, citizen participation in the political and electoral process, etc., (3) respond to requests for assistance from private and public entities engaged in the judicial process, such as those involved in public defender programs, and (4) support non-partisan groups which focus their attention on justice issues or the political process.

The government that is elected to office in 1989 to replace the present administration will inherit an economy struggling to grow under free market conditions. Failure of that government to achieve growth and equity could discredit the consolidation of both democratic institutions and free market economics, thereby bringing about a reversion to the authoritarian-statist policies of the past. USAID will explore the possibility of providing ESF support to the newly elected government to lend assistance to Panama's efforts to consolidate democracy and make the transition to market-led economic development.

E. Strategy Implementation

Successful attainment of our objectives requires that USAID resources be targeted at activities which yield the greatest economic and social returns. The growth targets could conceivably be achieved by exceptional expansion of the banking sector and the Colon Free Zone. Such growth would, however, not be accompanied by significant secondary effects on the economy of Panama and would contribute little to the alleviation of unemployment. We also note that the growth of those two sub-sectors can hardly be influenced by external donor assistance. We will direct our activities and resources to those sub-sectors: (1) which have clear growth potential, (2) whose growth yields widespread secondary benefits, (3) on which external assistance can have significant impact, and (4) which will have major employment generation effects.

In support of democratic processes, USAID will direct resources to activities: (1) which offer the opportunity for tangible improvements in political or judicial processes and institutions, (2) in which USAID involvement can make a useful contribution, and (3) for which there is a high degree of receptivity and a low potential for adverse political fallout.

Further, in keeping with our commitment to private enterprise as the "engine of growth", and our commitment to reducing the role of government in the productive sectors, USAID will channel our resources through the private sector to the greatest extent possible. Recognizing, however, that government has an important role to play in supporting the private sector as it enters an increasingly free market, we will support those governmental activities which contribute to the success of private enterprise.

While pursing its economic objectives USAID will continue to monitor the population program and assist in maintaining the diminished rate of population growth which was achieved by the now terminated POP II project. We will monitor A.I.D. Washington funded intermediaries who will work to extend family planning techniques and contraceptive information to low income populations in the Metropolitan Area of Panama City and to rural residents who have not had access to such services.

1. Policy Changes and Implementation

USAID will support free market policy evolution through on-going projects and through new activities. We will continue to fund policy studies in the Ministry of Planning and will fund additional complementary studies through private sector organizations. These studies will focus on the analysis of the impact of current policies on the competitive position of specific industries and on the interrelationship of the domestic cost structure to export sector costs. We expect that the results of these studies, expressed in non-technical terms, will bring about widespread understanding of the burdens that businesses and consumers now bear under present policies and will engender more receptivity to free market policies.

In the agriculture sector USAID will continue to provide policy and sectorial planning assistance to MIDA, and to assist that agency to dismantle its market intervention mechanisms and to refocus and better administer those activities which assist private agriculture to respond to the new policies and regulations.

USAID proposes to assist the Ministry of Commerce and Industry to restructure its organization and operations to bring about unified and coherent policy responses by the Ministry and its two semi-autonomous appendages, the Investment Council of Panama (ICP) and the Panamanian Institute for Foreign Commerce (IPCE). The three institutions interface more intimately with the private sector than any other agency of government. Their effective participation in the formulation and implementation of policies are essential to successful advance toward free market conditions.

We anticipate that proposed policy changes may produce short term dislocations of greater severity in some sectors than in others. We may find the use of ESF appropriate in those instances. However, we will be aware of the possibility of obtaining de facto policy changes through appropriate project design and will include appropriate provisions in new projects to the degree feasible.

USAID notes the importance of coordinating our policy interventions with other donors and will intensify our coordination efforts in-country. However, we call upon AID/W to inform us of assistance initiatives being considered by the IDB and others so that, together with AID/W, we may influence the targeting and volume of such assistance to affect favorably policy evolution.

2. Sectorial Programs

We will concentrate USAID resources on Agriculture, Industry, Housing and Tourism. These sectors offer growth potential well above the levels projected under the "base case" scenario of the IBRD. External and internal demand is more than adequate to absorb the products and services which the four sectors could provide. Their growth depends upon the ability of those sectors to respond to demand. The contributions of the USAID program to sectorial growth will depend upon (a) the supply potential of each sector, and (b) the influence which our program will have on the fulfillment of that potential.

a. Agriculture Sector

1. Attainable Growth

The base case projects an annual average growth rate of two percent over the period 1985-1991 for a total GDP increment of $501 million in this sector. USAID's target scenario calls for an annual average growth of 3.5 percent over the same period, yielding a total GDP increment of $547 million. We postulate that, with better focusing of external assistance on specific types of agricultural and marine production, the higher growth rate can be attained.

The labor generation implications of agricultural sector growth are especially favorable. Past output/employment ratios for the sector in Panama indicate that each $1 million in output generates 184 jobs. Thus, growth of $102 million by 1991 could generate an average of 3,125 jobs per year. While some of these jobs will be seasonal or part time, they will make a significant contribution to the alleviation of unemployment and help stem migration from rural to urban areas. To the degree that agriculture growth is accompanied by efficient production it will stabilize or reduce consumer costs. This would have the dual effect of raising real income throughout the economy and would increase Panama's overall competitive position.

Panamanian agriculture is inefficient, with yields for major crops which are lower than the international and South American averages. However, the potential for increased production is excellent. Transfer and adaptation of known technology can increase crop yields five fold on the fertile uplands, and three fold on low-land soils. The uplands are especially suited to production of temperate climate crops which are in demand in U.S. and Caribbean markets. The lowlands are suited for special tropical crops which are increasingly in demand in the U.S., South America and the Caribbean. Livestock production, which has been inhibited by price controls on domestic sales and quotas on exports, can, with relief from these constraints, be increased several fold by shifting feed sources from natural forage to cultivated pastures and/or to supplemental feed crops.

New agriculture and marine-based production is expected to be a major contributor to growth, but all of the new production will not be additive. Nevertheless, all indications point to a large expansion in output of marine based foodstuffs.

Underutilization of present agriculture land and the availability of virgin lands in Darien province provide a base for large production increases through land use intensification and expansion of farm lands. Marine resources and aquaculture are only marginally exploited. About 2,300 hectares of natural mangrove and salt water ponds are now successfully producing shrimp, and these could be expanded to 15,000 hectares. Shallow and deepwater scallop fishing is a new growth sub-sector. Crabs and spiny lobster off the unexploited Pacific Coast appear available in commercial quantities. Conditions on the Atlantic Coast are reported to be ideal for production of King Crab.

2. Program Response

USAID's agriculture program will focus on: (a) the production and marketing of aquaculture and marine based food products, (b) the production and sale of new specialty crops for export, (c) assistance aimed at efficient production of staples for the domestic market, (d) programs of privatization, de-regulation and institutional reform, and (e) programs of natural resource management, in response to increasing problems of degradation of soil and water resources.

USAID will direct the bulk of its assistance to the first two areas, working with private sector groups. The third area will be pursued through modifications in the focus and activities of the Panamanian extension service. For example, extension services to the larger commercial farmers could be privatized, and public extension programs could concentrate on smallholders and cooperatives. Our continued support to the extension service will condition assistance to producers of staples on the gradual elimination or reduction of price controls, price supports, and protective tariffs which now affect such producers. We will provide training to extensionists in specialized production which can be transmitted to small producers.

Essential research on the production of staples and most of the new agricultural products has been carried out. The USAID will refocus its support for agriculture research, concentrating on those crops for which Panama has a competitive advantage.

USAID will devote resources to the development of adequate external and domestic agriculture marketing services by drawing upon the capacity of existing institutions to identify markets and, to the extent practicable, improve the performance of those institutions. We will offer marginal support to agencies which are not part of the traditional agriculture governmental complex. We anticipate working with the Panamanian Institute for Foreign Commerce (IPCE) for agriculture marketing services; MICI's Department of Marine Resources for assistance to the sea food producers; and the Investment Council of Panama for increasing foreign investment in Panamanian agriculture. We will, however, channel the bulk of our assistance efforts through the new, private National Productivity Council (CONDEPRO) and its affilated cooperatives and producer associations. We will draw heavily on the International Executive Service Corps (IESC), upon specialized personnel obtained through arrangements with U.S. growers and distributors, and on specialized contractors.

The USAID program will bring product-specific technical assistance and services to farmers, fishermen, food processors, and will link the producer to external buyers. It will also introduce and support appropriate sanitary controls to insure acceptability of Panamanian agriculture and marine products in world markets. Through public, and more heavily through private agencies, the program will support the introduction of new products, improve the productivity of existing producers, and provide assistance and financing for food processors. It will include assistance in quality control, packing, shipping for compliance with the regulations of importing countries.

Similar assistance will be provided to growers of crops which can be produced competitively for the domestic market. Every effort will be made to reduce impediments to the import of food stuffs which cannot be produced competitively locally. USAID will also assist the GOP in planning its response to donor conditionalities.

Conservation and better management of the natural resource base is important for attainment of growth in the sector over the five year period and is critical to long term multi-sectorial growth. With Panama's limited resource base and the advanced stage of resource degradation, increases in agricultural production and productivity can only occur with improved land use practices and more appropriate management of natural resources. USAID's assistance in natural resource management and conservation consists of activities that will: (a) promote soil conservation and watershed management in critical areas such as the Panama Canal; (b) protect fragile upland and areas which have strategic biologic or genetic resources; (c) improve the management of the remaining natural forests for sustained production; (d) promote commercial reforestation by the private sector to supply future industrial wood requirements and to reverse negative trade balances for forest products; and (e) develop and implement a national resource policy and actions that will regulate the use, conservation and preservation of Panama's fragile natural resources. These activities were initiated on a limited basis under the Watershed Management Project, and will be expanded under the upcoming Natural Resources Management Project.

b. <u>Manufacturing Sector</u>

1. <u>Attainable Growth</u>

This sector, under the base case projections would grow at an annual average rate of two percent, yielding a GDP increment of about $53 million by 1991. Our target scenario projects a 3.7 percent annual average growth rate, yielding an increment of about $103 million. The attainment of that level of growth would generate about 9,400 new jobs, or an average of slightly less than 1,600 per year.

The manufacturing sector, which includes agro-industry, derives its comparative advantage from Panama's geographic position, the convenience and stability of a U.S. dollar based economy and the disparity between Panamanian costs and those of Northamerican, European and the major Far Eastern industrial nations; further improvements in the Panamanian labor code and in labor practices an reduction in other factor costs, would greatly increase its cost advantages. Nevertheless, even under current conditions Panama is an attractive alternative to production sites in those countries. Its relative stability also makes it more attractive than lower cost sites in some Central America or Caribbean nations in which social unrest is evident.

New and increased manufacturing production is expected to be brought about as a result of: (a) U.S. producers seeking relief from domestic cost pressures by placing new production in stable areas; (b) U.S. and South American producers manufacturing items which can enter the U.S. duty free under CBI incentives; (c) Asiatic producers, in light of growing protectionist sentiment in the U.S., wishing to position themselves for continued access to U.S. markets; (d) U.S., Asian, and Panamanian producers of garments availing themselves of quota positions and responding to the opportunities provided by 807 and 807a provisions of the Tariff Schedule of the U.S.; (e) producers of heavy speciality items requiring ready access to international shipping facilities; and (f) domestic producers with little opportunity for growth in domestic markets responding to foreign market opportunities.

From studies carried out by the ICP and confirmed by "potential investors", wearing apparel, light assembly, light manufacturing and agro-industry are areas of prime interest. Yet, other industries as diverse as production of steel tubing and wood treatment operations are being actively considered by foreign and domestic investors. A broom plant has been established, is successfully exporting to the U.S. and now is preparing to produce for the European market.

Foreign owned apparel manufacturing plants which began investing in Panama in 1984, and which introduced sophisticated production techniques, have dispelled some of the lingering doubts about Panama's potential competitiveness in foreign markets. Those plants contributed heavily to the $10 million increase in garment production which took place over the first three quarters of 1986, and they continue to expand. The demonstrated effect of productivity consciousness has not been lost on the Panamanian business community. Its members have shown a marked interest in exporting and in reducing costs of domestic oriented production. More than 2,000 businesses and individuals have joined a recently formed private sector productivity organization, the National Productivity Council (CONDEPRO). If the GOP adheres to its tariff reduction schedules, productivity improvement and export efforts will become increasingly important in business planning.

2. Program Response

Our industrial sector program is designed to provide assistance for market identification, investment promotion, developmental finance for the export sector, developmental finance for small business, productivity improvement and development of new exportable products. It will also facilitate reduction of government intervention in the market and refocussing the primary role of government from regulation of the private sector to support of that sector.

The credit components are in place. The government sponsored market information service has been instituted and must now be more fully professionalized and expanded through contractual arrangements with private marketing specialists. The Investment Council of Panama is functioning as an investment promotion agency. It provides excellent services to potential investors once they are in Panama, but is performing its research and promotion functions inadequately. USAID has taken actions to restructure and strengthen that institution. Because of the importance of investment promotion to Panamanian economic growth, USAID will seek to deepen the involvement of private sector organizations in direct or peripheral roles in such promotion.

Productivity improvement and activities which support the introduction and competitive manufacturing of new products are now of the highest program priority. USAID will support a major productivity improvement campaign and new product development effort to be undertaken by CONDEPRO, and will draw on regional programs for additional assistance. That program will draw heavily on the IESC and other specialized contractors. We anticipate that many of the new products will be based on agriculture raw materials or food stuffs, thus linking the Mission's industrial program to its agriculture program. The agro-industry effort will result in substantial backward linkages to agricultural production. Agro-industries will be the major beneficiaries of the productivity and new product development program. The growth of the agro- industry sub-sector, which accounts for about half of manufacturing GDP, will be determined largely by the agriculture sector's ability to produce at competitive prices.

USAID assistance program to the industrial sector parallels that of our agriculture program. It will increasingly use private sector instruments to bring product-specific assistance to producers, support the flow of market information upon which the producers can predicate their investment decisions, and support the evolution of free-market policies under which investment decisions will be made.

c. Housing Sector

1. Attainable Growth

The base case projects a two percent average annual growth in construction, yielding a GDP increment of about $29 million by 1991. Our target scenario sees construction growing at an average of about seven percent per year, yielding an increment of $114 million. Attainment of that level of growth would generate about 6,800 new jobs, or about 1,200 per year. The large variation between the two scenarios is attributable to the high degree of sensitivity of this sector to aggregate investment.

Given the stimulus of an economy growing at about five percent per year, non-housing construction would be expected to expand at about twice the rate projected in the base case. A $100 million public infrastructure construction program currently being planned with the Inter-American Development Bank would, if fully implemented, add about $50 million (in 1985 dollars) in value added to the sector. The recently announced IDB housing loan to the GOP and the USAID Private Housing Guarantee Program, together with local contributions to the programs, will inject about $73 million in new funds into the housing sector. This would result in approximately $36.5 million in additional value added in the construction sector. USAID expects an increase of middle class housing starts as the economy picks up. Reduction in construction costs and evidence of profitability in low cost house construction will be required before latent demand in this sub- sector is converted to effective demand.

2. Program Response

Given the importance of housing as an economic growth stimulator and the undoubted social benefits of low cost housing programs, we will explore the possibility of an additional Housing Guarantee (HG) Program. That program would be linked to the existing FY 86 HG program and would involve a variety of private sector credit institutions in the financing of low cost housing. USAID will also explore the feasibility of privatization of the National Mortgage Bank as an element of a proposed new HG.

Measures to reduce production costs of low cost housing will have the dual effect of increasing effective demand and increasing profit margins. We are urging the GOP to reduce the excessively high construction standards of the building code which now apply to low cost housing. We find them responsive to this suggestion. USAID will continue to press for reductions in scheduled import tariffs which currently add enormously to factor costs. Through CONDEPRO and its construction sector affiliate Panamanian Chamber of Construction (CAPAC), we will provide assistance to improve the productivity of the sector.

d. Tourism Sector

1. Attainable Growth

North American tourists, reacting to unpleasant events in the middle East, Europe and some parts of the Caribbean region, are seeking new areas for travel and recreation in this hemisphere. Economic revival in South America is also increasing recreational travel, and there is a continuing explosion in international travel from prosperous far Eastern countries. The evidence of demand is overwhelming.

Panama's ability to respond to such demand is circumscribed to some degree by the availability of hotel accommodations, the relative inaccessibility of the most desirable recreational sites, e.g. San Blas and the Pacific Beaches, lack of resort facilities, the relatively high cost of air travel from U.S. cities, and a hitherto uncooperative attitude of government agencies whose activities impinge on the convenience and safety of travelers, factors which affect tourist attitudes.

Two developments may bring about a return to the growth of tourism at the average 10.6 percent rate registered during the period 1970-1975. The pending acquisition by private parties of government owned and operated hotels presages a private sector campaign to increase the tourist flow to Panama. Abetted by a government-sponsored advertising campaign, the hotel and travel industry could enter into a new round of growth. Given the fact that there is considerable excess capacity in this industry, growth could take place with relatively minor investment.

With adjustments to its tourist infrastructure and services, the Panamanian tourism sector should be able to perform as well as it did in earlier years, particularly with visitors from tour boat stop-overs. Travelers entering from Costa Rica, the ports of Balboa and Cristobal, and from Torrijos International Airport during the peak years of 1978-1980 totalled approximately 668,000. In 1984, the number had dropped to about 427,000, a net loss of about 241,000 visitors.

Reversion to visitor volumes of the late 1970s would result in at least $19 million in sector growth by 1991. The readily exploitable potential offered by cruise visitors -- over 83,000 cruise boat passengers pass through the Canal each year -- could be a major component of that growth. The growth of domestic tourism as a result of economic growth and influenced by actions taken to improve facilities for foreign tourists, will further add to sectorial growth. Although the dollar volume of such growth is small, it will have a significant effect on employment. On the basis of value added/ employment ratios calculated by USAID, the sector will produce about 1,700 new jobs.

2. Program Response

USAID's program in support of tourism will rely heavily on components of existing USAID projects. These will be supplemented by technical assistance to Business Associations and the Panamanian Institute of Tourism (IPAT). The Export Development Finance Project (525-0261) and the Small Business Development Project (525-0240) will place greater emphasis on tourism projects. The former will be encouraged to utilize its project development grant funds to assist in the final design of tourist related projects and to take the lead in arranging financial packages in support of these projects. The Small Business Project would focus more of its resources to assist small and medium sized businesses to adapt services to tourist needs and to refurbish and improve small resort hotels. USAID will use technical assistance to explore the possibility of establishing a national monuments trust which could be responsible for cleaning, repairing and maintaining historical sites. We will also explore the possibility of having all or some part of the present responsibilities of IPAT transferred to the trust.

USAID will help private sector firms and individuals respond to tourism opportunities to develop new service products or improve the provision of existing service. CONDEPRO and its tourism oriented affiliates will be the channel for such assistance. Our assistance to public sector entities will only rarely be direct. Normally we will provide assistance to private associations, enabling them to interact with and lobby the GOP for changes in policies or performance of government agencies. We will respond to training requests from private sector individuals and businesses as part of our planned Productivity and Product Development Project now being designed.

e. Public Sector Investment

1. Attainable Increments

Reduction in government administration outlays and elimination of subsidies to state owned enterprises (SOE's) could permit application of the resultant savings to the investment budget. A reduction in public employment at the rate of one or two percent a year is likely to be politically acceptable as the Panamanian economy resumes growth. Thus, over the five-year period, between $25 million and $67 million net of severance payments could be diverted from consumption to investment outlays.

The disinvestment by privatization is likely to produce a one-time revenue yield, but until the market value of SOE's can be properly determined we cannot estimate those revenues. Estimates of current subsidies to SOE's are at this point unreliable, but at least $50 million in net savings by subsidy reduction could be generated over the five year period by privatization. Thus, savings generated by reduction in government payrolls and privatization could free between $75 million and $117 million for new public investment.

2. Program Response

USAID's support activities, for reduction of the unnecessary GOP fiscal burdens occasioned by its direct participation in production activities, will be modest and discreet. They will be calculated to fully utilize the leverage provided by IBRD and A.I.D. conditionalities and by the economic realities which Panama must face. At the request of the President of Panama, USAID has contracted with an experienced and respected Latin American national to assist in the development of a serious but politically acceptable divestiture effort. The contracted advisor who has had successful experience in divestiture and privatization on behalf of his own government, would, if the plan now under development is acceptable, be retained to assist in its implementation. To further support that implementation we will authorize use of the resources of the already funded Policy Studies Project (525-0250) to permit the GOP to contract for additional technical assistance.

Our support of activities which lead to reduction of public payrolls is closely linked to our proposed efforts to make government more responsive to the needs of the private sector. In our program for restructuring the Ministry of Commerce and Industry, reduction of workforce will be one objective. The workforce reduction will be linked to clearly defined functions of the Ministry and to the manpower requirements to carry out those functions. The Ministry has a relatively small staff and consequently personnel reductions in that agency will not have a major effect on the reduction of the large Panamanian bureaucracy. Conversely, the reduction should not meet with unyielding hostility. The precedent set would, however, contribute importantly to subsequent GOP efforts for restructuring and personnel reduction in other agencies and establish a demonstration which could usefully influence future civil service reforms.

2. Democratic Processes

1. Attainable Improvements

Short-term and long-term outlooks for improving democratic processes vary considerably. It is possible that the accelerated democratization now underway in Latin America will fully penetrate Panamanian society over the long term. In the short-run, improvements in democratic processes which threaten vested economic and political interests are likely to be resisted. USAID believes that efforts to rationalize the public administration and administrative law systems will be feasible. USAID also believes that, under pressure from the private sector, a more open budgetary process can emerge. From discussions with the Association of Mayors and with persons of influence in the municipalities, we gather that improvements in local government would be welcomed.

The existence of a functioning political party system already allows for ample public debate. USAID believes that party competition, if not driven to the point of extreme polarization of political forces, can generate an effective lobby for more open government in general.

2. Program Response

USAID's support of the CAPS and the COSPAE programs will continue throughout the period. Their dimension will be determined by the availability of funds. Those programs which are designed to expose potential Panamanian leaders to U.S. values, techniques and institutions are expected to provide a democratic leaven to Panamanian society. The training offered under the program will continue to include skills which have a direct relationship to Panama Canal operations thus advancing the Panamanian capabilities for full management of the waterway.

To supplement these programs USAID intends to assist local organizations in the development of projects aimed at focusing attention on problems and issues of democracy, e.g., voter education and issue orientation. The business youth program will stress the role of democratic processes in the functioning of a free market. USAID will, in conjunction with the Association of Mayors, design and support a program for municipalities, in which latent sources of local revenues will be activated to support the provision of services to local communities.

USAID has noted favorable reactions from some elements of the public sector as well as private sector to the Regional Administration of Justice Program. USAID believes that continuation of the availability of a wide range of assistance instruments should be made known to the Panamanian public at large. USAID will support various institutions, such as the Panama Bar Association, the Law Faculty of the University of Panama, the arbitration office of the Chamber of Commerce and law libraries, and will work together with public institutions, to the extent possible, to assist their efforts to improve the functioning of the judicial process. The program may also finance seminars, short courses, conferences and exchanges with U.S. and Central American legal scholars and bar associations. USAID will also support exchanges of U.S. and Panamanian legislators and continue to provide opportunities for justice sector practitioners to participate in regional workshops and training programs.

As the national elections approach, USAID expects to receive requests for assistance in the mechanics of the electoral process. We believe that such assistance could under certain circumstances be appropriate. Such requests will be carefully reviewed and assistance will be tailored to respond to critical needs of organizations and institutions which play important roles in the electoral process and which contribute substantially to the country's overall democratic development.

III. STAFFING LEVELS

The current USAID DH-staffing level for the bilateral program is nineteen (19) positions. USAID also carries under its ceiling two regional positions---the Regional Contracts Officer and the Regional Legal Advisor---for a total USDH level of twenty-one (21). In addition, the USAID provides administrative and logistical support to the Regional Housing and Urban Development Office which has three USDH positions. The Mission USDH level has been declining over the past few years. Currently the USDH level is about two-thirds the FY 1980 level. As a result of our efforts to continue focussing and streamlining our program, we plan a reduction in one USDH position in FY 1988 and another in FY 1991.

No immediate changes are planned in the FNDH staffing levels. However in FY 1991 we plan to reduce the FNDH staffing level by three (3) positions.

Staff Requirements

	FY 87	FY 88	FY 89	FY 90	FY 91	FY 92
USDH	21	20	20	20	19	19
FNDH	37	37	37	37	34	34
FSN (PT)	1	1	2	2	2	2

IV. RESOURCE REQUIREMENTS

Per guidance from AID/W we have straight-lined the FY1987 Development Assistance levels through the planning period. We have shown an ESF grant level for the CAPS program which will allow the program to continue at the same level of activity throughout the period. The ESF levels are programmed at ten million dollars per year. Additional ESF funding may be required to assist the GOP as it undertakes necessary but difficult reforms over the programming period. We anticipate that the IBRD and IMF will continue to take the lead in macro level structural adjustment programs. The USAID assistance would be complementary to those efforts and focussed on sector and sub-sector policy issues and activities related to economic growth and strengthening democratic processes.

Finally, additional resources may be made available to the GOP as a compensatory offset to its reduced sugar quota. We are currently exploring arrangements for provision of 416 commodities which would be sold by the GOP to the private sector. The currency generated would be utilized as mutually agreed by USAID and the GOP.

RESOURCE REQUIREMENTS
($000)

APPROPRIATION ACCOUNT	FY '88	FY '89	FY '90	FY '91	FY'92	TOTAL FY88-92
	------------CDSS PLANNING PERIOD------------					
AGRICULTURE, RURAL DEV. AND NUTRITION						
TOTAL	10,000	10,000	10,000	10,000	10,000	50,000
GRANT	5,000	5,000	5,000	5,000	5,000	25,000
LOAN	5,000	5,000	5,000	5,000	5,000	25,000
POPULATION						
TOTAL	300	300	300	300	300	1,500
GRANT	300	300	300	300	300	1,500
LOAN	0	0	0	0	0	0
EDUCATION AND HUMAN RESOURCES						
TOTAL	4,100	4,100	4,100	4,100	4,100	20,500
GRANT	3,100	3,100	3,100	3,100	3,100	15,500
LOAN	1,000	1,000	1,000	1,000	1,000	5,000
SELECTED DEVELOPMENT ACTIVITIES						
TOTAL	5,000	5,000	5,000	5,000	5,000	25,000
GRANT	3,000	3,000	3,000	3,000	3,000	15,000
LOAN	2,000	2,000	2,000	2,000	2,000	10,000
TOTAL DA ACCOUNTS						
TOTAL	19,400	19,400	19,400	19,400	19,400	97,000
GRANT	11,400	11,400	11,400	11,400	11,400	57,000
LOAN	8,000	8,000	8,000	8,000	8,000	40,000
ECONOMIC SUPPORT FUND (CENTRAL AMERICAN PEACE SCHOLARSHIPS)						
TOTAL	10,000	10,000	10,000	10,000	10,000	50,000
GRANT	10,000	10,000	10,000	10,000	10,000	50,000
LOAN	0	0	0	0	0	0
TOTAL RESOURCE REQUIREMENTS	29,400	29,400	29,400	29,400	29,400	147,000
GRANT	21,400	21,400	21,400	21,400	21,400	107,000
DA	11,400	11,400	11,400	11,400	11,400	57,000
ESF	10,000	10,000	10,000	10,000	10,000	50,000
LOAN	8,000	8,000	8,000	8,000	8,000	40,000
DA	8,000	8,000	8,000	8,000	8,000	40,000
ESF	0	0	0	0	0	0
HOUSING GUARANTEES (Non add)	0	15,000	0	10,000	25,000	50,000